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Supreme Court of the United States

October Term, 1952

No. 521

CENTRAL BANK, a Corporation, *Petitioner*

vs.

THE UNITED STATES, *Respondent*

On Writ of Certiorari to the United States Court of Claims

REPLY BRIEF FOR PETITIONER

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I.

WITHHELD TAXES ARE NOT A PART OF WAGES

The respondent in its brief seems to argue that the taxes withheld by Graham Ship Repair Company were a part of unpaid wages. Thus, the respondent says (Resp. Br. p. 8) that "* * * the tax indebtedness was an indivisible part of the obligation to pay wages * * *". This argument is amplified by the respondent on page 13 of its brief, as follows: "Stated another way, a portion of

the wages which accrued in performing the contract had to be paid directly to the Government." Again, on page 15 of its brief the respondent says that "* * * the tax obligation was an indispensible ingredient of the obligation to pay wages * * *."

This attempt to attribute to the tax monies withheld the character of unpaid wages is completely unsound.

In *United States Fidelity and Guaranty Co.* v. *United States*, 201 F. (2d) 118, United States Court of Appeals, Tenth Circuit, 1952, the United States contracted with Leavell & Co. for the construction of a building. Leavell & Co. subcontracted part of the work to Kendrick Electric Co., Inc., hereinafter called Kendrick. United States Fidelity & Guaranty Company executed a surety bond for Kendrick, guaranteeing payment of all obligations of Kendrick under the subcontract. Kendrick assigned to said surety company, as security, all payments and monies to which it might become entitled under the contract. Kendrick defaulted in making sundry payments due under the subcontract for materials, supplies and equipment. Kendrick also withheld income taxes and social security taxes out of wages paid by it to its employees engaged in performance of the subcontract, and failed to pay such withheld taxes over to the United States. Leavell & Co. made demand upon United States Fidelity & Guaranty Company, as surety for Kendrick, to pay the unpaid bills for materials, supplies and equipment, and the surety company paid these bills. At that time there was due to Kendrick from Leavell & Co. on the subcontract, $4,960.24. The surety company claimed the right to said sum under its assignment of contract proceeds made by Kendrick. The United States asserted a right to said sum, to apply upon the liability of Kendrick to the United States for income and social security taxes withheld by Kendrick and not paid over to the United States.

The trial court decided this issue in favor of the United States; it did this upon the theory that the taxes withheld by Kendrick constituted wages; that the failure to pay these taxes constituted a breach by Kendrick of its obligation to pay all wages; hence, that the surety company was obligated to pay said withheld taxes, as being part of unpaid wages.

The surety company appealed to the United States Court of Appeals for the Tenth Circuit. On this Appeal, the United States argued the same theory that the trial court had adopted, as set forth. The Tenth Circuit Court of Appeals reversed. The majority of the Court spoke in part as follows:

> "In its conclusions of law the trial court held that Kendrick agreed to and accepted full and exclusive liability for the payment of these withholding taxes and that it was obligated to the United States for their payment and that under the surety company's bond for the performance of Kendrick's obligations it became liable for their payment.
>
> "It is true that in Paragraph 12 of the sub-contract Kendrick assumed and accepted 'full and exclusive liability for the payment of any and all contributions or taxes for Unemployment Insurance and/or Old Age Retirement Benefit, Pensions, or Annuities, * * *' imposed by the Government and measured by the wages paid to its employees. But this did not create the liability or Kendrick's part for the payment of these taxes. It was merely declaratory of Kendrick's existing liability under the federal tax laws." (p. 119)
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> * * * *
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> "* * * It is thus clear that Kendrick's liability for the payment of these taxes arises by virtue of law and not because of any contractual acknowledgment of the existly legal liability." (p. 120)
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> * * * *
>
> "* * * However, from the statutes and regulations as set out it seems clear that when an employer with-

holds the tax from an employee's wage and pays him the balance the employee has been paid in full. He has received his full wage. Part of it has gone to pay his withholding tax and the balance he has. The employer has discharged his contractual obligation to pay the full wage. Thereafter there remains only his liability for the tax which he has collected. That is a tax liability for which he alone is liable to the Government as for any other taxes which he may owe." (p. 120)

• • • • •

"Finally it is contended that the Government's lien for these taxes is superior to the surety's claim to these funds. This contention has been decided against the Government in a series of cases. As pointed out in the application for the payment bond, Kendrick assigned to the surety company all its right title and interest in and to any funds it was entitled to receive from the principal contractor, Leavell, to indemnify it against liability to which it might become subjected by virtue of Kendrick's breach of its construction subcontract. At the time the surety company became liable and discharged its liability by paying all material, supply and labor claims, the fund in question was due Kendrick from Leavell. When surety is called upon and makes good under its contract of suretyship upon default of its principal, it acquires an equitable lien against any sum remaining in the hands of the one for whose protection the bond was written due to its principal upon discharge of his obligation under its bond. This equitable lien relates back to the date of the contract and is superior to a Government lien for unpaid taxes subsequent to the date of the contract of suretyship although prior to the date of payment by the surety." (p. 121).

• • • •

In this case, the assignment of contract proceeds by Kendrick to the surety company was valid. However, said assignment could not protect the surety company as to claims arising under or related to the contract, because the surety company was obligated by its bond to

perform all of Kendrick's obligations under the subcontract. Therefore, the decision of the Tenth Circuit Court of Appeals that the liabilities of Kendrick to the United States for withheld taxes were statutory liabilities, and not contractual liabilities, amounts to a holding that the said liabilities for withheld tax monies arose *independently of the contract.*

Accord: *United States v. Swallow Engineering Co., Inc. & Firemen's Fund Indemnity Co.*, 100 F. Supp. 796, now on appeal to the United States Court of Appeals, Ninth Circuit. See also *Grasso v. Oehmann* (1947) 54 A (2d) 570, Municipal Court of Appeals, D. C.

The issue decided by the Tenth Circuit Court of Appeals in the United States Fidelity & Guaranty Company case is thus closely parallel to the issue presented in the case at bar and the case appears to be persuasive, to the effect that liability of a contractor for embezzlement of withheld taxes is an indebtedness arising independently of the contract.

II.

THE 1951 AMENDMENTS TO THE ASSIGNMENT OF CLAIMS ACT OF 1940, IN THE LIGHT OF THE LEGISLATIVE HISTORY OF THE AMENDING ACT, ARE DECLARATORY OF THE TRUE MEANING AND SENSE OF THE STATUTE.

The respondent, in its brief, calls attention to the 1951 amendments of the Assignment of Claims Act of 1940 (set forth in Respondent's Brief, App. p. 42-45), and takes the position that those amendments constituted a modification of the 1940 Act and not a clarification of it (Respondent's Brief, pp. 26-31). The respondent further argues that such amendment thus indicates that the Assignment of Claims Act of 1940 did not preclude setoff of taxes, such as the ones involved in the case at bar.

Although the amending Act contains the specific provision "Except as herein otherwise provided, nothing in this Act, as amended, shall be deemed to affect or impair rights or obligations heretofore accrued", a consideration of the legislative history of the amending Act shows that the rulings of the Comptroller General in this and other cases as to the construction to be given the Assignment of Claims Act of 1940 had completely destroyed the effectiveness of that Act and had made it impossible for that Act to accomplish the very purpose for which it was enacted; that the urgency for inducing banks to finance small contractors for essential defense work was so imperative that something had to be done immediately; that affirmative action could not be delayed until judicial review of the Comptroller's rulings could be concluded; and that the amendments which specifically referred to the subject matter of those rulings and made those rulings inoperative, was enacted to make certain that the Assignment of Claims Act of 1940 would accomplish what it was originally intended to accomplish.

The situation is shown by Senator Robertson's report, to the Senate, for the Senate Committee on Banking and Currency, as to the proposed 1951 Amendment (82d Congress, 1st Session, Senate, Report No. 217 p. 2). He spoke in part as follows:

> "It had also been the understanding of banks that the statute protected them against set-off by the Government on account of any claims by the Government against the contractor arising outside of the terms of the assigned contract. However, in an opinion dated May 15, 1950, the Comptroller General ruled that claims by the Government against a contractor on account of unpaid social-security contributions and withheld income taxes were claims which did not arise independently of the assigned contract.
>
> "These and other similar rulings of the Comptroller General to the same effect have operated to

deter banks from making loans to Government contractors on the security of assignments of claims because of uncertainty as to the nature and extent of other indebtedness of a contractor to the Government, such as liability resulting from renegotiation or unpaid income taxes, on account of which the Government might later reduce payments due to the assignee bank, or recover payments already made. As a result, the current V-loan program has been seriously retarded; and many of the smaller contractors having a large volume of Government contracts but a small net worth are presently unable to obtain the financing necessary to enable them to perform their contracts."

The Report also sets forth an expression of the views of the Office of Defense Mobilization (p. 5) which reads in part as follows:

"However, certain recent rulings by the Comptroller General, which have in effect limited the *intended* scope of the Assignment of Claims Act, have resulted in a general unwillingness on the part of commercial banks to undertake defense production financing. One such ruling relates to the right of the Government to recover payments previously made to the assignee bank. Another creates some uncertainty concerning the right of set-off on the part of the Government. The banks do not consider such matters as the usual commercial risks which they are willing to accept. Accordingly, they feel they should not be held liable for actions beyond their control or for amounts not commensurate with the risk." (Emphasis added)

The Report of the Committee on the Judiciary, of the House of Representatives, is to the same effect (82d Congress, 1st. Session, House of Representatives, Report No. 376, at pages 1-3). In that Report, Congressman Lane spoke in part as follows (p. 1):

"The Assignment of Claims Act of 1940 was enacted for the purpose of inducing private financing

institutions to participate in the financing of defense contractors under the defense program of that period.

"Under this statute, banks were able to finance defense contractors on the security of such assignments of claims where other forms of security were not available and guaranteed loans made under the very successful V-loan program of World War II were generally secured in this manner.

"However, within the last year and a half the Comptroller General in certain opinions has held that payments already made to an assignee bank pursuant to the Assignment of Claims Act may subsequently be recovered by the Government on account of an overpayment due to price revision and that certain types of claims of the Government against a contractor, *which had previously been regarded as claims arising 'independently' of the assigned contract*, might be set off by the Government in making payments to an assignee bank. Because of these opinions, the banking institutions are reluctant to make this type of loans, with the result that many defense contractors—especially the smaller manufacturers and producers—are presently unable to obtain the necessary financing for the performance of their defense contracts." (Emphasis added.)

While the 1951 amendment is in terms not retroactive and has no direct application to the case at bar, nevertheless the petitioner submits that the legislative history of the amendment may properly be consulted as a guide to the intention of Congress in previously enacting the Assignment of Claims Act of 1940.

The above Reports show that the intention of the Assignment of Claims Act of 1940 was to protect the financing banks against set-off for subsequently accruing liabilities of the contractor which did not arise directly out of the performance of the contract and that such had been the general understanding of the matter in the business world. These things are demonstrtaed in the hearings before Subcommittee No. 4 of the Committee

on the Judiciary, House of Representatives, 82d Congress, First Session, held March 7, March 21 and April 12, 1951, relating to the proposed 1951 Amendment. In those hearings the general counsel to the Board of Governors of the Federal Reserve System said in part as follows (p. 4):

> "In the second place, banks had understood that the 'no set-off' provision of the statute protected them from a reduction of payments due under an assigned contract on account of any claims of the Government against the contractor except claims arising under the terms of the contract itself. The Comptroller General, however, has held that claims of the Government against the contractor for unpaid social-security contributions or withheld income taxes of its employees are claims which arise out of the assigned contract rather than independently of the contract, and that, therefore, they may be set off against the payments due an assignee bank. Such an interpretation of the statute suggests the possibility that the Government might also attempt to reduce payments owing to an assignee bank because of some other indebtedness of the contractor to the Government, such as liability for renegotiation or even for unpaid income or excess profit taxes of the contractor.
>
> "We would like to emphasize at this point that we are not attempting to comment upon the legal correctness or incorrectness of the various rulings of the Comptroller General on this subject. The question is not whether the rulings are legally justified. Our concern is with the effect that the rulings are having upon the program for guaranteed loans and therefore upon the effectiveness of the financing of defense production, particularly by the smaller contractors.
>
> "Banks and other financing institutions are unwilling—and can hardly be expected—to assume the abnormal risks of loss which are imposed upon them by these rulings. Consequently, in many cases they are refusing to make loans to the small marginal businesses on the security of assignments of claims. The

larger contractors—the prime credit risks—are not suffering. It is the little contractor, without any adequate collateral security to offer except an assignment of his defense contracts, who is finding it difficult or impossible to obtain needed financing."

Other portions of these hearings are to the same effect (pages 9, 22, 40, 42, 64, and 70).

The effect of the 1951 amendment in the light of its legislative history, as to the Assignment of Claims Act of 1940, was "merely declaratory of the true meaning and sense of the statute"; *Wetmore v. Markoe*, 196 U.S. 68, 25 S. Ct. 172.

The petitioner believes that in the presentation of its case in its opening brief, it has adequately answered all other points and contentions advanced by respondent in its brief.

CONCLUSION

It is respectfully submitted that the Assignment of Claims Act of 1940 was made for the specific purpose of encouraging banking institutions to loan money to contractors and to assure banks that they could rely upon assignments of contract proceeds as security for their loans, protected against all claims of the Government against the contractor excepting such claims which arise directly under the contract; that claims for taxes withheld by the contractor were not intended by Congress, nor generally understood by the business world, as being a type of indebtedness arising under the contract; that an indebtedness arising out of an embezzlement by the contractor of withheld tax monies held by him in trust for the United States was an indebtedness entirely unrelated to the contract and arising independently of the contract; and that the Court of Claims, in reaching the

conclusion that such indebtedness was an indebtedness arising under the contract, committed error which should be reversed.

Respectfully submitted,

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